



SEC

OFFICE of INVESTOR
EDUCATION and ADVOCACY

Post-Madoff Reforms

In December 2008, Bernard L. Madoff admitted to perpetrating a massive Ponzi scheme. Shortly thereafter, the SEC began taking decisive and comprehensive steps to reduce the chances that such frauds will occur or be undetected in the future. Today, the agency is continuing to reform and improve the way it operates. Among other things, the SEC has been:

- Revitalizing the Enforcement Division
- Revamping the handling of complaints and tips
- Encouraging greater cooperation by 'insiders'
- Enhancing safeguards for investors' assets
- Improving risk assessment capabilities
- Conducting risk-based examinations of financial firms
- Improving fraud detection procedures for examiners
- Recruiting staff with specialized experience
- Expanding and targeting training
- Improving internal controls
- Advocating for a whistleblower program
- Seeking more resources
- Integrating broker-dealer and investment adviser examinations
- Enhancing the licensing, education and oversight regime for 'back-office' personnel

Revitalizing the Enforcement Division:

Under the leadership of a new Enforcement Director, the SEC is restructuring the division to better ensure that it focuses on significant cases that will have a meaningful impact. The restructuring will reduce bureaucracy and

speed up the enforcement process by removing a layer of management in the 1,100 person division. The newly structured division will include specialized units that will enable staff in those units to concentrate their expertise in focused areas and help detect patterns, links, trends and motives. In addition, the Division has streamlined internal processes to make investigative procedures more efficient.

Revamping the Handling of Complaints and Tips:

Each year, the SEC receives a massive number of tips and complaints. In order to improve the way it handles them, the agency contracted with a federally funded research and development center to create a centralized system for managing this information. Already, the team has reviewed and analyzed existing intake procedures and is currently working to improve the process for collecting, recording, investigating, referring and tracking this data. As part of the process, the agency is also working on a system that will apply risk analytics, which will help to reveal links, trends, and patterns that might not be visible when each complaint is examined one at a time. Additionally, the Enforcement Division is in the process of creating a special unit to carefully screen and assign tips to the proper investigators.

Encouraging Greater Cooperation by 'Insiders':

The SEC is crafting agreements to secure the cooperation of individuals who are on the "inside" of companies engaged in fraudulent activity. These cooperation agreements, similar to those used by criminal law enforce-

ment authorities, provide that insiders who offer truthful evidence and agree to cooperate and testify would be eligible for a possible reduction in sanctions. Such cooperation agreements could produce witnesses and key information early in investigations, enabling the agency to build stronger cases more quickly.

Enhancing Safeguards for Investors' Assets:

In December the SEC will consider adopting rules that would better protect clients of investment advisers from theft and abuse. The rules, proposed in May, would provide greater assurance to investors that their accounts contain the funds that their investment adviser and account statements say they contain. Among other things, the proposed rules would encourage investment advisers to place their clients' assets in the custody of an independent firm, unlike Bernard Madoff did.

Surprise Exams:

One proposal would require investment advisers who control or have custody of their clients' assets to hire an independent public accountant to conduct an annual "surprise exam" to verify those assets actually exist. This surprise examination would provide another set of eyes on the clients' assets, thereby offering additional protection against the theft or misuse of funds.

Third Party Reviews:

A second proposal would apply to investment advisers who do not use independent firms to maintain their clients' assets. Such advisers would be required to obtain a third party written report assessing the safeguards that protect the clients' assets. The report — prepared by an accountant registered and inspected by the Public Company Accounting Oversight Board — would, among other things, describe the controls that are in place to protect the assets, the tests performed on the controls, and the results of those tests. Existing rules make no distinction between an investment adviser whose affiliate holds its clients' funds and an investment adviser that

uses a truly independent custodian.

Improving Risk Assessment Capabilities:

The SEC is improving its risk assessment procedures and techniques, agency-wide, to better identify areas of risk to investors. For instance, the agency is enhancing the information that financial firms submit and is improving techniques to better identify those particular firms that warrant a closer look. The agency is also increasing collaboration with third parties and other government agencies. Finally, the agency created a new Division of Risk, Strategy and Financial Innovation which will provide new expertise in risk assessment, financial products and financial engineering.

Conducting Risk-Based Examinations of Financial Firms:

The SEC dispatched its examiners to conduct a "sweep" of firms that present certain risk characteristics to ensure, among other things, that the clients' assets in fact exist. Such risks include advisers whose clients' assets are held with an affiliate, as opposed to an independent entity; hedge funds that seem to have "smooth" or outlier returns; firms that use an unknown auditor or no auditor at all; firms with a disciplinary history; and broker-dealers that sell an affiliate's hedge fund or limited partnership.

Improving Fraud Detection Procedures for Examiners:

The SEC instituted measures to improve the ability of examiners to detect fraud and other types of violations. Examiners across the country now routinely reach out to third parties such as custodians, counter-parties and customers during exams to verify the existence and integrity of client assets managed by the firm. In addition, the measures include more rigorous reviews of firms before the examiners enter the premises, and a more complete exam guide that focuses not only on obvious signs of fraud but also more subtle signals that deserve closer inspection, such as a firm using an unknown accountant. The measures also include expanded use of exams of an entire entity when firms have joint or dual registrants such

as affiliated broker-dealers and investment advisers.

[Recruiting Staff with Specialized Experience:](#)

The SEC has been bringing in new staff with diverse skill sets to expand its knowledge base and improve its ability to assess risk, conduct examinations, detect and investigate wrongdoing, and focus our priorities. Some initial examples included:

[Senior Specialized Examiners:](#)

The agency has hired new staffers to the examination unit — and will bring on board more — who have specialized experience in areas such as trading, operations, portfolio management, options, compliance, valuation, new instruments and portfolio strategies, and forensic accounting.

[Additional Staff with Capital Markets Expertise:](#)

The agency has been hiring additional staff with expertise in modern financial products and techniques — such as derivatives and hedge fund activities. Now, other staffers can tap into that expertise to help them identify emerging issues and understand the ways the industry is changing. Such expertise can also be helpful in efforts to improve the techniques used in examinations and the collection and analysis of data.

[Expanding and Targeting Training:](#)

The SEC has provided — and will continue to provide — staff training related to hedge funds and specialized products; derivatives and options; the verification of trades and custody arrangement; and the use of databases maintained by exchanges and clearinghouses, among other things. Additionally, hundreds of staffers have been training to become Certified Fraud Examiners, and the SEC is expanding the availability of programs for staffers to become Certified Financial Analysts and Chartered Alternative Investment Analysts.

[Improving Internal Controls:](#)

The examination unit and enforcement division each has implemented a quarterly review program to help ensure that important issues are resolved in a thorough and timely manner and that no exam or investigation falls through the cracks. As part of the quarterly review programs, managers will meet to review and discuss all open exams and investigations and address whether additional expertise is needed to resolve issues, finalize exams and bring investigations to conclusion.

[Advocating for a Whistleblower Program:](#)

The SEC has requested expanded authority from Congress to reward whistleblowers who bring forward substantial evidence about significant federal securities violations. In proposed legislation that the Chairman sent to Congress, a fund would be established to pay whistleblowers using money collected from wrongdoers that is not otherwise distributed to investors. Variations of this legislation are being considered by both the House and Senate.

[Seeking More Resources:](#)

The SEC has been seeking additional funding to hire more examiners who can go into more financial firms to see whether they are in compliance with the law, as well as for more enforcement staff who can bring more enforcement cases when fraud and other violations of the law are found. In recent years, the SEC has not had adequate resources to oversee the securities industry. For example, the SEC has just over 450 people in its exam program to examine the more than 11,000 regulated investment advisers and 8,000 mutual funds. Congress is considering legislation that would increase both the level and flexibility of funding for the SEC.

[Integrating Broker-Dealer and Investment Adviser Examinations:](#)

The SEC has instituted several measures to integrate the broker-dealer and investment adviser examination programs. The New York Regional Office, for example, has

adopted a protocol that will integrate examination teams to make sure people with the right skill sets are assigned to examinations. Under the new protocol, a single team of examiners, drawn from the broker-dealer and investment management units, will jointly examine selected firms to ensure that the examination team includes those most expert in the subject of the exam. In addition, the examination program has expanded opportunities for examiners to cross-train and increase coordination between broker-dealer and investment management staff on their examination plans.

Enhancing the Licensing, Education and Oversight Regime for “Back-Office” Personnel:

Working with senior SEC staff, FINRA has committed to establish a new system to enhance the oversight and professional requirements of personnel performing back-office functions at broker-dealer firms. “Back-office” personnel typically perform critical custody, accounting, transfer agency and account maintenance functions. They have an important role that must be performed with skill and integrity. Under the regime FINRA is developing, certain back-office personnel would be subject to licensing and education requirements as well as enhanced oversight. Such a regime would further promote the qualifications and professionalism of those performing back-office functions so that client accounts are better protected.

